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LAW DEPARTMENT

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August 15, 2005

Commissioner Kristin K. Mayes  
Arizona Corporation Commission  
1200 West Washington  
Phoenix, Arizona 85007-2996

Re: APS Application for Surcharge; Operation of the Surcharge and  
Purchase Supply Adjustor: \$100 Million Surcharge Cap;  
Docket No. E-01345A-05-0526

Dear Commissioner Mayes:

Arizona Public Service Company ("APS" or "Company") appreciates this opportunity to respond to your letter of August 4, 2004. In summary, APS believes its July 22, 2005 Application for a Power Supply Adjustment ("PSA") surcharge is not only appropriate and consistent with the August 18, 2004 Settlement Agreement ("2004 Settlement"), the testimony in support thereof, and Decision No. 67744 (April 7, 2005), but that such Application was required by the very terms of the Commission's Decision. Thus, APS will address the issues raised by your letter in the order presented.

**ISSUE NO. 1: "The PSA has not been implemented; is APS' request for the surcharge premature?"**

The PSA has been implemented. The PSA is part of the Company's tariffs as authorized by Decision No. 67744. It was filed with the Commission and became effective April 1, 2005. See Exhibit A, attached. The PSA consists of both an annual adjustment factor and a PSA surcharge. At present, as indicated in the attached tariff sheet and in conformance with both the 2004 Settlement and Decision No. 67744, the annual adjustment factor is \$0.0000 per kWh. Upon the effective date of the PSA rate schedule (April 1, 2005), APS began deferring fuel and purchased power

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costs in excess of the base fuel amount plus the annual adjustment factor. Thus, the PSA has been fully implemented, and the Company's request for a PSA surcharge is not premature.

**ISSUE NO. 2: "Evidentiary hearing witnesses."**

APS has diligently reviewed the entire transcript of the evidentiary hearing on the PSA provisions of the 2004 Settlement. APS has not found an instance where any of the PSA witnesses indicated that a PSA surcharge could not or would not be implemented prior to any change in the annual adjustment factor on April 1, 2006. APS does not interpret the testimony quoted in the letter as expressing an opinion on the subject of whether there would or could be a PSA surcharge request prior to April 2006, nor does APS believe any of these witnesses excepting Mr. Wheeler were asked to offer such an opinion:

Q. [From Commissioner Mundell] That was my next question. The first adjustment would be April, '06?

A. BY MR. WHEELER: Unless the \$50 million trigger is exceeded, in which case we could make a filing and you could determine whether to make an interim adjustment, [but] assuming it isn't reached, then it would be '06 for the first adjustment. [Settlement hearing Tr. Vol. I, p. 162. Emphasis supplied.]

But, as you may recall that under the terms of the 2004 Settlement, which represented the context in which each of these witnesses responded to any questioning, APS was not obliged to seek a PSA surcharge irrespective of the size of the PSA bank balance, and therefore no witness could have affirmatively indicated whether or not such a surcharge application would be forthcoming prior to April 2006.

It was an amendment by the Commission of the 2004 Settlement in Decision No. 67744 that affirmatively required a surcharge application, whether prior to or after April 2006, under specified circumstances: "In no event shall the Company allow the bank balance to reach \$100 million prior to seeking recovery or refund." Decision No. 67744 at 17. The Commission did not in any respect qualify the clear mandate expressed by the words "In no event . . . ."

**ISSUE NO. 3: "ALJ Farmer's interpretation during Open Meeting."**

Like the witnesses at the hearing on the 2004 Settlement, ALJ Farmer was not asked and did not appear to volunteer an opinion on the timing of any future PSA surcharge request. Nor did she appear to say that the total of any PSA surcharge(s) and the four mil annual PSA adjustment factor could not exceed \$200 million in any year.

Her Open Meeting statements, as expressed in the letter, seem to merely indicate that if fuel and purchased power costs increased by \$200 million, only \$100 million would be collected through the 4 mil annual PSA adjustment factor with the balance having to be collected through one or more surcharges. This is, of course, the case, but her statement appears not to address the timing of any application for such a surcharge. It neither states nor implies that APS cannot seek a surcharge prior to April 2006. And again, like the evidentiary witnesses, Judge Farmer was speaking before the discussion later in the Open Meeting of the Commission Amendment relating to the PSA surcharge mechanism and requiring a surcharge application prior to the PSA bank balance reaching \$100 million.

**ISSUE NO. 4: "Plain language of the Settlement Agreement [2004 Settlement]."**

Attached as Exhibit 4 is Section IV of the 2004 Settlement, which sets forth the terms of the PSA. Nowhere does it limit either the timing or sequencing of an application for a PSA surcharge. But, it is clear under what circumstances APS may request such a surcharge - namely whenever the bank balance of deferred costs reaches \$50 million:

When the size of the balancing account reaches either plus or minus \$50 million, APS shall have forty-five days to file for Commission approval of a surcharge to amortize the over-recovered/under-recovered balance and to reset the balancing account to zero. If APS does not wish to reset the balance to zero, it shall file a report explaining why." See Paragraph 19 (e) of the 2004 Settlement.

APS does agree that the PSA bank balance itself is, in a sense, the residual of 90% of the difference between incurred fuel and purchased power costs and the base fuel cost plus the annual PSA adjustment factor. It does not agree that there can be no recoverable residual costs until after the re-setting of the annual PSA adjustment factor in April 2006.<sup>1</sup> An annual adjustment factor presently exists and per the 2004 Settlement and Decision No. 67744, it is currently set at zero. Thus, 90% of the difference between the base fuel cost (\$.020743 per kWh) and the annual PSA adjustment factor (\$.0000 per kWh) has been properly deferred in the PSA bank balance. And that is what APS has done since April 1, 2005, when the PSA became fully effective pursuant both to Decision No. 67744 and the PSA tariff schedule the Company filed in compliance with such Decision. To contend otherwise would seriously undermine the very essence and frustrate the purpose of having the PSA.

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<sup>1</sup> Your letter is not entirely clear on this point, and it may well be that your focus is on the timing of any recovery of amounts deferred into the PSA bank balance prior to April 1, 2006 rather than on recoverability itself. If so, I apologize for our confusion.

**ISSUE NO. 5: "Plain language of the Order [Decision No. 67744]."**

The language from Decision No. 67744 cited in your letter supports the requirement that APS seek a surcharge prior to the bank balance reaching \$100 million. It also indicates that the PSA will not permit deferral of costs prior to April 1, 2005. This clearly contradicts the notion discussed above that there can be no "residual" costs to defer prior to April 2006. In short, Decision No. 67744 imposes no limit on either the timing or number of PSA surcharge applications (although there are, of course, other limits on cost recovery built into the PSA), but it does impose a mandatory obligation upon APS to seek such a surcharge prior to the bank balance reaching \$100 million.

**ISSUE NO. 6: "Surcharges are adjustors to adjustors."**

This issue does not really go to the timing of PSA surcharge applications but rather the merits of permitting surcharges in addition to regular PSA adjustments. Decision No. 67744's adoption of a PSA that included a surcharge mechanism in addition to annual adjustments to the PSA factor resolved the issue in favor of such surcharges. In doing so, the Commission recognized that these two components of the PSA are intended to accomplish two separate, albeit related, functions. The regular April PSA adjustment is intended to better reflect and recover ongoing fuel and purchased power costs by using the preceding year's fuel and purchased power cost per kWh. The PSA surcharge is to recoup past fuel and purchased power costs in excess of the base fuel amount plus the annual PSA factor.

The Commission's position in Decision No. 67744 was hardly new or radical. The standard purchased gas rate adjustment mechanism, which was developed by Commission Staff and upon which the PSA mechanism was modeled, uses a bank balance and surcharge mechanism:

[A]nd one of the things we did was we modeled this approach after what you [the Commission] do already on the gas side, so this is pretty much consistent, I'm reminded of it on the gas side, so we didn't particularly think this [the PSA] was an odd approach if you're going to establish an adjuster."  
[Director Johnson at Special Open Meeting of March 28, 2005, Tr. Vol. II, p. 301.]

Because gas utilities are permitted to adjust their PGA factors monthly rather than just annually, the bank balances do not grow so large so quickly as has been the case with APS, but the principle is exactly the same.

**ISSUE NO. 7: "Stringent prudence review of the requested fuel costs."**

As part of the 2004 Settlement, APS agreed the Commission could conduct a review of the Company's fuel and purchased power costs at any time and that it would refund any amounts collected through the PSA that were determined to have been imprudently incurred. If there were a prudence question raised, it could be handled after-the-fact, perhaps in a general rate proceeding:

There were many protections put on the power supply adjuster as it was negotiated that would limit the volatility of that adjuster. It had the 90/10 split that provides for an incentive for the company to minimize costs that would be flowing through that adjustment mechanism. It had the 4 mil bandwidth cap per year that would ease the ups and downs of the adjuster and reduce the volatility of the customers. It has the prudence reviews, the Commission could continue to maintain its prudence reviews of the company's power supply and fuel acquisition programs, and if there were any disallowances of those costs, there could be refunds to customers. [RUCO Chief Counsel Wakefield at Special Open Meeting of March 28, 2005, Vol. III, p. 298. Emphasis supplied.]

In this instance, the requested PSA surcharge is over a two year period, giving more than sufficient time for any necessary review to take place before APS will have recovered the bulk of the deferred fuel and purchased power bank balance.

That being said, APS believes it has acted prudently in its procurement of fuel and purchased power, including appropriate price hedges on such commodities. And under Commission regulation [A.A.C. R14-2-102 (A) (3) (I)], APS is afforded a strong presumption that its actions are indeed prudent.

As noted in the Application for a PSA Surcharge, APS hedging policies have produced savings of approximately \$30 million through August. See APS Application for a PSA Surcharge at 3. But hedging cannot offset the fact that APS sales are now made at a higher fuel and purchased power cost than the average cost reflected in the base fuel cost allowance. Neither can hedging change the fact that summer costs are higher than the average year round per kWh cost represented by the base fuel cost allowance. Thus, PSA bank balances will grow during the summer regardless of price trends or the ability to mitigate price volatility through hedging.

APS is prepared to discuss the operation of its generating units in whatever forum the issue is raised. But prudence is not perfection, and unplanned outages are an expected part of all power plant operations. Every generating unit ever made has had forced and unplanned outages. Indeed, the Commission has labeled proposals to *per se* disallow the costs of unplanned outages in excess of some historical level as "an unreasonable and draconic position." Decision No. 55118 (July 24, 1986) at 13.

Such outages occur unexpectedly, but not uniformly throughout the year, or for that matter, not uniformly from year to year. APS realizes that there have been several unplanned outages in its base generating units that have clustered in May, June and to a lesser extent July, but where will we be for all of 2005? The projected capacity factor for the Company's base load generation during 2005, even given the outages in the first half, is 84.2%. In comparison, the industry average for the past four years for which data is available is 74% (2000), 74.1% (2001), 75.5% (2002), and 75% (2003). Although looking at industry data does not in and of itself provide an absolute standard by which prudence can be measured, it can support the already existing presumption of prudence required by Commission rule. And, looking at overall plant performance rather than focusing on a single unit or plant has also been endorsed by prior Commission precedent: "Likewise, a realistic analysis of operating performance must look at both the 'successes' and the 'failures' if it is to avoid setting unobtainable goals of absolute perfection." *Id.* at 20.

As to the specific instances cited in your letter, the Palo Verde Unit 3 pressurizer heaters installed during the fall 2004 refueling outage for reliability reasons. However, a number of them failed unexpectedly after unit startup following refueling and would have had to have been replaced eventually or risk a forced outage at some future date. The decision was made to do this replacement before the peak of the summer was here and before there was a forced outage at a time not of the Company's choosing. The other items mentioned in your letter as taking place during the May 23<sup>rd</sup> to June 24<sup>th</sup> outage were examples of doing previously unscheduled maintenance tasks during periods when the unit is out-of-service for other reasons. That way, they don't have to be done at some future date. The July 6 to July 13<sup>th</sup> outage was taken at that time because the Company knew it could cover the shortfall from the market at a reasonable cost but did not have that same assurance if the outage were delayed or if the equipment problems led to a forced outage later in the summer.

And though the Palo Verde outages did impact the Company's fuel and purchased power costs and thus the level of PSA deferrals to date, by far the large majority of the cost deferrals were due to higher gas, power and coal costs combined with seasonal factors (summer months have uniformly and significantly higher power and fuel costs as compared to the annual average of such costs upon which the base fuel cost of \$.020743 was premised), and sales growth. The amount of fuel and purchased power costs that will already be absorbed by APS through the operation of the 90/10 sharing mechanism is itself comparable to the estimated cost of the unplanned Palo Verde outages.

Finally, the situation at Westwing did not result in any additional fuel and purchased power costs to APS or its customers. At no time prior to that substation being returned to full capacity in July, 2005 did APS experience any transmission restrictions

on either its ability to import power into the Valley or its ability to export power out of the Valley.


**ISSUE NO. 8: "The \$100 million surcharge – hard-capped, one time event or perpetual recovery."**

The surcharge mechanism in the PSA operates just as it does in the many gas utility PGAs authorized by this Commission. It is used to correct over/under-recoveries of cost that are not picked up by periodic adjustments to the PSA/PGA adjustment factor. There was never any suggestion in either the 2004 Settlement or Decision No. 67744 that the settling parties or the Commission intended the surcharge mechanism to be a "one-shot" event or that there was any sort of "cap" on cost recoveries under the PSA other than the overall \$776 million annual "cap" on total fuel and purchased power recoveries through the combination of the base fuel and purchased power factor (the \$.020743 per kWh) and the PSA adjustment factor (presently \$.0000 and capped by Decision No. 67744 at \$.004 per kWh). At no time did the Commission indicate during its deliberations on either the \$100 million surcharge application amendment or the limitation on the annual PSA factor adjustment to a cumulative four mills that their intent or operation would result in automatic disallowances of otherwise prudent costs. Rather, the discussion was to the contrary.

However, the ability of the PSA to recover the Company's legitimate fuel and purchased power costs either through the annual PSA adjustment factor or through PSA surcharges is far from "perpetual." The 4 mill cumulative limit on the PSA adjustment factor combined with the overall \$776 million "cap" were added to encourage the Company to file a general rate case during 2005, at which time the base fuel cost and operation of the PSA can again be reviewed by the Commission.

I hope this letter has addressed the issues raised by your letter. Please feel free to contact me should you have any additional questions concerning the APS Application for a PSA Surcharge.

Sincerely,



Thomas L. Mumaw

Attorney for Arizona Public Service Company

cc: Chairman Jeff Hatch-Miller  
Commissioner Mike Gleason  
Commissioner William Mundell  
Commissioner Marc Spitzer  
Parties to the Docket



## ADJUSTMENT SCHEDULE PSA-1 POWER SUPPLY ADJUSTMENT

### APPLICATION

The Power Supply Adjustment ("PSA") shall apply to all retail electric schedules with the exception of Solar-1, Solar-2, SP-1, E-3, E-4, E-36 and Direct Access service. All provisions of the customer's current applicable rate schedule will apply in addition to this charge.

### PSA ADJUSTOR RATE ANNUAL ADJUSTMENT

The main components of the PSA are: 1) a risk sharing mechanism whereby APS and its customers share in the costs/savings on a 90% customer, 10% APS basis; 2) a bandwidth that limits the amount the PSA Adjustor Rate ("Adjustor Rate") can change over the entire term of the PSA to plus or minus \$0.004 per kWh; 3) a balancing account; 4) a balancing account surcharge mechanism, separate from the Adjustor Rate, to clear the balancing account under circumstances described below; and 5) the inclusion of off-system sales. The monthly PSA calculations shall be adjusted for the calculated net savings from the methodology approved in Decision No. 67504 from the PPL Sundance docket. The calculation method is set forth in the filed Power Supply Adjustment Plan for Administration (the "Plan"). Standard Offer services covered by this charge include a Base Rate Power Supply Cost of \$0.020743 per kilowatt-hour. An annual adjustment to the Base Rate Power Supply Cost will be made through a change in the Adjustor Rate that is based upon the annual total of PSA retail energy sales (less E-3, E-4 and E-36 sales) and power supply costs. The annual costs are compared to the base rate costs to determine the year's total over/under collection after the 90%/10% sharing incentive. The annual amount of PSA Retail Power Supply Costs that can be used to calculate the annual Adjustor Rate cannot exceed \$776,200,000.

The Adjustor Rate is calculated annually and the total (credit)/charge collection amount is recovered over twelve months. The Adjustor Rate is applied to the customer's bill as a monthly kilowatthour charge and is the same for all affected customer classes. The Adjustor Rate will change in billing cycle 1 of the April revenue month and it will not be prorated. The Adjustor Rate must remain within the Bandwidth that limits the amount it can increase or decrease each year.

### RATES

The charges shall be calculated at the following rates:

#### PSA Adjustor Rate

|         |            |         |
|---------|------------|---------|
| All kWh | \$0.000000 | per kWh |
|---------|------------|---------|

#### Amortization Surcharge

|         |            |         |
|---------|------------|---------|
| All kWh | \$0.000000 | per kWh |
|---------|------------|---------|

### AMORTIZATION SURCHARGE

If the size of the Balancing Account reaches plus or minus \$50 million, the Company has forty-five days to either file a request for Commission approval of an Amortization Surcharge, or an explanation of why such a surcharge isn't necessary. Should the Company seek to recover or refund an amount from the Balancing Account, the timing and manner of recovery, or refund, will be addressed at that time. In no event shall the Company allow the Balancing Account to reach \$100 million prior to seeking recovery or refund.<sup>1</sup> Following a proceeding authorizing recovery or

<sup>1</sup> The Commission Staff believes that the operation of the \$100 Million "cap" on the Balancing Account requires further review and discussion prior to final approval of the Plan for Administration for the PSA.





## ADJUSTMENT SCHEDULE PSA-1 POWER SUPPLY ADJUSTMENT

refund of a bank balance between \$50 million and \$100 million, the balance considered in the proceeding shall be reset to zero unless otherwise ordered by the Commission.

### BALANCING ACCOUNT

APS shall establish a PSA Balancing Account. Entries to the Balancing Account shall be made each month as follows:

1. A debit or credit entry equal to the difference between the Post-Sharing (Over)/Under Collection and the sum of the amounts recovered by the Applicable Adjustor Rate. The Post-Sharing (Over)/Under Collection is calculated by taking amount recovered through the Base Rate Power Supply Cost of \$0.020743 and subtracting it from the PSA Retail Power Supply Cost. The product of that subtraction is then multiplied by 90% to reduce the recoverable costs in accordance with the 90%/10% sharing incentive.
2. A debit or credit entry equal to the kilowatthours billed for the month under the rate schedules subject to the Adjustor Rate multiplied by the effective Amortization Surcharge. If an Amortization Surcharge is not in effect, then no entry will be made.
3. A monthly debit or credit entry for interest to be applied to the account balance based on effective one-year Nominal Treasury Constant Maturities rate that is contained in the Federal Reserve Statistical Release, H-15, or its successor publication. This is called the Monthly Interest and is used above in the Adjustor Rate calculations. The interest rate will be adjusted annually on the first business day of the calendar year in the same manner as the APS customer deposit rate.
4. A debit or credit entry for refunds or payments authorized by the Commission.

### COMPLIANCE REPORTS

The Adjustor Rate and Balancing Account calculations and supporting information will be provided to the Commission monthly as specified in Decision No. 67744. Workpapers and other documents supporting the calculations that contain proprietary or confidential information will be provided to the Commission Staff under an appropriate confidentiality agreement. APS will keep fuel and purchased power invoices and contracts available for Commission review. All of the information is available during the year, upon Commission request. The Commission has the right to review the prudence of fuel and power purchases and any calculations associated with the PSA at any time. Any costs flowed through the PSA are subject to refund, if those costs are found to be imprudently incurred.

### DIRECTLY ASSIGNED POWER SUPPLY COSTS EXCLUDED

In cases when power supply costs are incurred for a specific customer or group of customers, the customer or group of customers will be directly charged the identified costs in accordance with the Plan. Power supply costs and related energy sales recovered through direct assignments for both existing and returning customers as described on rate schedule RCDAC -1 will be excluded from the computation of the above charges applied to other Standard Offer service customers.